

BANK OF ALBANIA'S MONETARY POLICY THROUGH OPEN MARKET OPERATIONS DURING 2001

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Keywords

- Monetary policy - Operational framework - Repurchase agreements -

The Bank of Albania's monetary policy to October 2000 was based on the application of direct monetary policy instruments. Found under the situation when the constant executive cuts of interest rates were not followed by commercial banks, the Bank of Albania, at the beginning of the third quarter 2000, deemed it necessary to re-design the operating framework, deciding to base its monetary policy on the application of market instruments. Repo rate already plays the core rate in the economy.

The Bank of Albania has made systematic improvements and changes in the operating framework, pursuing its target achievement during 2001. Concretely in February 2001, the operating framework was completed with permanent facilities (overnight deposits and overnight credits), with auctions of outright sale/purchase transactions and with the fast Repo auctions (daily), as well as there were made improvements in the current market regulations, whereas, in October 2001 a new structural operation, that of monthly and quarterly Repo auctions, was approved. This made the Bank of Albania's operating framework be expanded and based on open market operations, permanent facilities and the required reserves. Improving and completing money market regulations with new elements enhance manoeuvring spaces of the Bank of Albania's policy.

Concretely:

- 1 Passing from multiple-price auctions to fixed Repo auctions in April helped sending clearer signals to the money market;
- 2 Using for the first time the overnight facilities provided by the Bank of Albania in withdrawing and injecting excessive reserves from the system. Their application brought interest rate stability in the money market, creating a visionary corridor for their oscillation within the limits established by the Bank of Albania. These interest rates are very important for signalling the monetary policy;
- 3 Approving and later on intervening for the first time with structural and settlement operations in the market, enabling the sterilization on stable market basis.

All of these helped the Bank of Albania to implement its monetary policy, which changed gradually depending on the performance of macroeconomic indicators retained from the previous year into a neutral and later on to a slight tightening policy.

Until March 2001, Repo agreements were applied as weekly auctions¹ with multiple prices and announced amount. The interest offered by the Bank of Albania was gradually stabilized at 6.5 percent. Through these auctions, the Bank of Albania intended to signalize the market about its easing monetary policy as well as to ensure information about bank assessment on money price in this market.

In the course of these auctions, it was noticed that their systematic frequency helped commercial banks to make a planned management of excessive reserves. However, plans on these investments met with limited possibilities for investing the excessive reserves. This was because banks competed in the auction, either for the amount or the interest rate. The withdrawal of excessive reserves from the system at predetermined limits by the Bank of Albania let out unused funds after the auctions. On the other hand, a feature of the first half of 2001 was the use

by the government of privatization receipts for deficit financing, besides other resources, which lessened the government demand, causing increase of outstanding liquidity in the market. All these made the monthly average of excessive reserves² oscillate at about Lek 4.3 billion.

In the situation of prevailing surplus in the market and limited possibilities for investments, commercial banks reduced the market rate, starting with the Repo rates offered in the auction as an effort to win in the auction. The declining average rate in Repo auctions started to be reflected in other money market rates but at different levels of flexibility. So the treasury bills yield demonstrated the highest level of flexibility. This happened because the system's reaction was almost strong and immediate regarding the reduction of government treasury bills yield. Commercial banks Lek deposit rates reflected a declining tendency with a lower degree of elasticity compared to the more delayed treasury bills yield from the moment of transmitting the signal to the market. Although the lending price generally manifested a falling tendency, it was also accompanied by increase in separate³ months of this period, reflecting the restricted role of lending in domestic currency. The presence of these factors in the market impedes the efficient implementation of monetary policy instruments. The commercial banks' reaction made them gradually reduce the high spreads between the applicable interest rates for lending and interest rates for accepting deposits. So for January - March '01, as a result of the reducing price, the monthly average of the differential accounted for 10.98 percent, from 15.73 percent in the fourth quarter of the year 2000.

What was noticed during this period was the lack of an orienting corridor for interbank market transactions. As a result, the level of interests in these transactions was not stabilized. The level of interest for the same term transactions moved in wide amplitudes, which for daily agreements oscillated around 5.0 – 6.0 percent and for weekly agreements fluctuated around 4.95 – 7.2 percent. Although the application of weekly repo auctions enforced restrictions to commercial banks, it provided

its results in livening-up the interbank activity. A modest increase of the interbank market was noticed for the period. The average monthly volume of transactions amounted to Lek 0.89 billion. The low volume of interbank market transactions was conditioned not only by the market over-supply, but also by its deficiencies for a normal and systematic functioning.

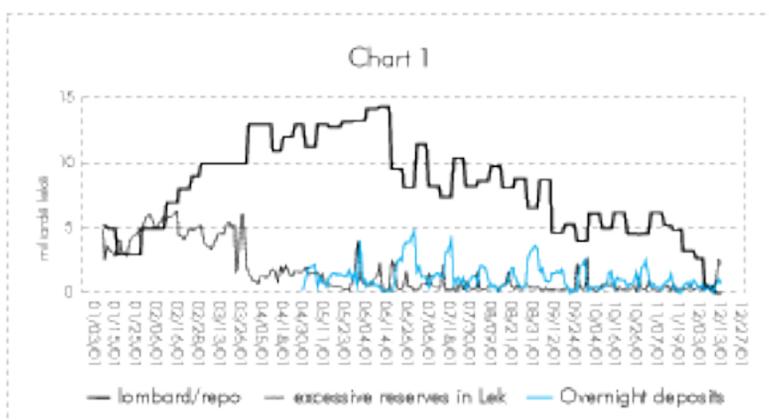
Based on domestic developments of economy, inflation indicators and other monetary developments, the Bank of Albania decided to change its monetary policy attitude from a soothing policy to a neutral stance. This corresponds to April-August 2001. The Bank of Albania continued to apply weekly fixed-price Repo auctions as the main operation of the interbank market. So, to decide the Repo rate, the Bank of Albania was based on the resulted average from multiple price auctions that were lately stabilized at about 6.5 percent. Changing the type of Repo auctions was aimed at stabilizing the market rates and resolving the problems evidenced during the first period.

Also, the Bank of Albania applied for the first time the permanent facilities, overnight deposits and credits. The applicable interest for these facilities is plus 2.5 percent to the Repo rate for overnight credits and minus 2.5 percent to the Repo rate for overnight deposits. The scope of using these facilities was to ensure the withdrawal or injection of daily liquidity by commercial banks, influencing the stabilization of market movements of daily rates, signaling the overall framework of monetary policy and serving as a corridor for daily rates in the market.

Placing a corridor for market rates recorded end of the period of the lack of stability in interbank market interest rates for various maturities. Right from this period the interest rates in the interbank market were stabilized, having the corridor set forth at the operational framework of the Bank of Albania as a reference. The interest for daily agreements oscillated by 4.25-4.5 percent and for weekly agreements by 6-6.7 percent.

The changes undertaken by the Bank of Albania created possibilities to commercial banks to invest all their excessive

liquidity planned for weekly maturity, solving the chronic problem of the market. In this period, the commercial banks' requested and accepted amount for weekly Repo auctions amounted to Lek 196.3 billion. Among others, it was noticed that besides excessive reserves of less than 7-day maturity, in some cases banks failed to anticipate the accurate amount of the liquidity to be invested in Repo auctions. This is so because during the weekly Repo auction day there are cases when banks are not notified of the results of the primary market auction.



Under these conditions banks used the facility of overnight deposits offered by the Bank of Albania to invest the excessive liquidity, having an interest return of 4.0 percent. This facility offered by the Bank of Albania had a massive application by all banks of the system. The total invested reserves in overnight deposits reached the amount of Lek 191.2 billion. As a result of all these changes, the monthly average of unremunerated excessive reserves decreased to about Lek 0.64 billion.

The withdrawal of all excessive reserves planned by commercial banks to be invested in weekly Repo auctions from the Bank of Albania helped in raising the interbank market activity compared to the first period. The average monthly volume of transactions reached to about Lek 1.6 billion.

The decrease of excessive reserves lessened the pressures for interest rate reductions in the market. Lek deposit rates and the treasury bills yield had an insignificant change, demonstrating the stabilization of these interest rates. In the meantime, the lending price in domestic currency continued to reduce, oscillating from one month to the other. As a result, starting from June 2001 and onward, for the first time the difference between the credit price and deposit rates in domestic currency maintained one-digit figures. This marked the period with the lowest spread from year 1997.

Parallel to investment forms of excessive reserves, commercial banks used the provided possibilities by the Bank of Albania to meet liquidity shortages, either the overnight facility or 5 percent of the required reserves in domestic currency. The overnight credit was applied at a low frequency and in a small amount compared to overnight deposit. The Bank of Albania reached the amount of Lek 4.2 billion, whereas the volume of ALL required reserves used by commercial banks accounts for Lek 5.3 billion.

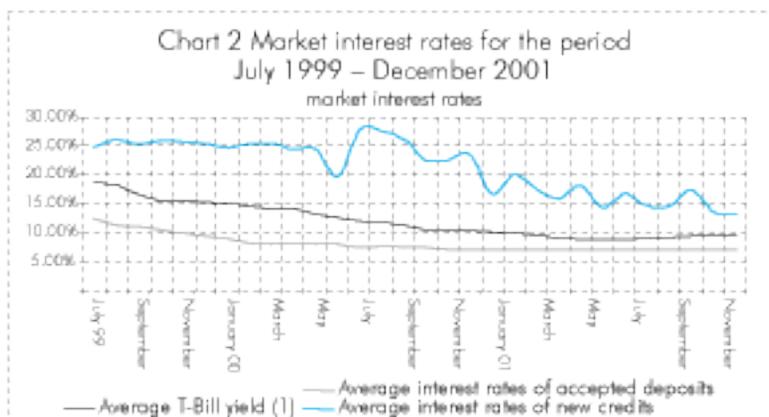
The change in the Bank of Albania's monetary policy stance, from easing to neutral, the application of new operations and the provision of facilities increased the manoeuvring spaces of second-tier banks. The operating framework let it up to the banks to decide the level of excessive reserves they must retain. Banks lessened the statement of excessive reserves at their desired rate, decreasing the pressures for the reduction of market rates. Parallel to this, establishing a fixed Repo rate brought about stabilization of market rates.

Based on the annual inflation rate during the first 7 months of 2001, its 5.6 percent rate at the end of July, expectations for rising inflation pressures as well as on other macroeconomic factors, the Bank of Albania decided to raise the Repo rate by 0.5 percent (50b.p.) The Bank of Albania transmitted this stance to the market, continuing to use weekly fixed-price Repo auctions as the main operation.

The primary and interbank market reaction was immediate, since interest rate rise was nearly at the same extent with that

signalized by the Bank of Albania. The stability created in the second period remained a typical feature. In the meantime, the increase of deposit rates was gradual and not as obvious as in the above markets. Therefore, our country's largest banks, such as the Savings Bank and the National Commercial Bank maintained unchanged deposit rates, while they raised the treasury bills yield, increasing the spread between the treasury bills yield and the new deposit rates.

Whereas the rest of the system generally reacted in accordance with Bank of Albania's signals, behaving as market competitors. These banks increased Lek deposit rates, besides treasury bills yield rise, maintaining the same interest spreads for domestic currency investments and for new deposits in Lek. In fact each bank's behaviour reflected the place they share in the market.



Taking into account the overall system, banks reaction was almost strong and immediate with respect to the rising yield of government treasury bills, feeble and delayed against time deposit rates in Lek and with an unclear effect on the lending price, because of the above-explained reasons. From August 20, 2001 to the end of the year, the banking system maintained low levels of excessive reserves. In the meantime, the end of the year was characterized by a low level of excessive liquidity caused by the increase of the money demand. In December '01,

the level of participation in Repo decreased a lot and moreover, banks did not participate at all in the last auction.

After a long period of non-application, Lombard facility as the last lending resource offered by the Bank of Albania was applied only on 31 December 2001 by two commercial banks.

NEW INSTRUMENTS

An instrument applied by the Bank of Albania for the first time for sterilization, on stable market basis are outright sale/purchase of securities. The Bank of Albania has performed two treasury bills sales in June and September '01 at the amount of Lek 4.9 billion each. In both cases, the Savings Bank was the buyer. In November 2001, Repo monthly auction was organized for the first time. Lek 2.0 billion was withdrawn from the banking system through it.

The Savings Bank was the winner. Thus, it comes out that the operational framework used by the Bank of Albania has managed to fully transmit its monetary policy to the banking system and influence the interbank market of lending and borrowing either through increasing the trade volume or through the direction of these market interests. Commercial banks have reacted to the Bank of Albania's monetary policy stance. The change of interest rates in the market has been at different levels of flexibility and lag conditioned by the domestic market development, the structure of financial markets, the place occupied by commercial banks, etc.

The restricted role of lending in domestic currency, materialized in the low level of credit market development in domestic currency, makes the monetary policy effect on other economic agents be modest. Repo rates will manage to fully transmit Bank of Albania's decisions to the economy after minimizing the monopoly position of the Savings Bank and rising competition in the market and a better co-ordination of monetary and fiscal authority and developing credit market to economy, and other

similar markets, such as that of securities, of capitals, of fixed assets, etc., as potential and important channels in transmitting the monetary policy decisions to the economy.

NOTES

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¹ Weekly auctions of repurchased agreements are of one week maturity and they are used to withdraw excess liquidity from the banking system.

² The average for January '01 – 20 March '01 (until the day when the overnight deposit is used).

³ Banks that lend the economy in Lek and the interest rates applied on credits depending on their maturity term changes almost every month. This brings high oscillations in the weighted average interest rate of credit in Lek.